Duty to Supervise Satellite Financial Planner Offices: The Growing Problem of Selling Away

Robert J. McGaughey[1]

For seven years, Peter McKinnon was a licensed financial planner working in Oregon for three large insurance/securities companies. For nearly all of this time, he had his own satellite office and sold securities and insurance products through these national brokers. All three brokers treated him as an independent contractor.

In 1999, McKinnon was terminated by his first broker for bad acts (likely settling a customer dispute using his own money and without telling his supervisor). His next broker placed McKinnon on enhanced supervision (but then forgot to tell McKinnon's immediate supervisor).

From 1999 to 2003, McKinnon stole more than $1 million from over a dozen clients – the sick, the unemployed, the very young – all without detection by his brokers. McKinnon did so by tricking his clients. He forged their names; one time forging his client's name and having his broker wire transfer $120,000 into McKinnon's own personal account.

McKinnon told the clients their funds were being invested into safe, government bonds. He personally typed up fake monthly statements for his clients showing steady growth in their funds. He even sent out bogus 1099s and his clients paid tax on their fictitious gain.

After 5-1/2 years, McKinnon was caught and is now serving 44 months in a federal penitentiary. I represented most of the victims in getting back their funds from McKinnon's brokers.

Selling away: a growing problem

More and more, national securities brokers are operating through "independent" satellite offices where there is little daily contact between the national organization and its "independent contractors." All too often, these contractors are poorly trained. All too often, the broker provides little oversight beyond marketing meetings and a once-yearly (often pre-announced) visit by a member of the broker compliance staff who makes a cursory review of a few files, sometimes files pre-selected by the contractor.

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[1] ROBERT J. McGAUGHEY practices in Portland in the areas of securities, shareholder, partnership and LLC litigation. He is the author of the Oregon Securities Law Handbook, the Oregon Corporate Law Handbook, the Washington Corporate Law Handbook, and co-author of "Oregon Securities Law," 1 Advising Oregon Businesses. He is the past Chair of the OSB Business Litigation Section and past Chair of the OSB Securities Regulation Section. He has served on the OSB Business Law Section's Legislation Task Forces regarding changes to Corporation Act in 2001, regarding Close Corporations in 1999, and regarding the LLC statute changes in 1995. He is a member of the Oregon State Bar and the Washington State Bar. His web site is at www.law7555.com.

Without better supervision, some of these independent sales representatives sell risky, unregistered securities schemes, borrow funds from elderly clients, and steal. Generically, such conduct is known in the industry as “selling away.”

Heightened regulatory concerns

Over the past ten years, securities brokers who operate through “independent contractor shops”, have been a subject of increased concern by both the SEC and the National Association of Securities Dealers (“NASD”).

The leading decision in this area is *In re Royal Alliance Associates*, Exchange Act Rel. No. 38, 174, 1997 SEC Lexis 113 (Jan. 15, 1997).

The SEC has elaborated on *Royal Alliance* in many of its subsequent decisions and *Red Alliance* has been confirmed and consolidated in NASD Notice to Members 99-45, “NASD Provides Guidance on Supervisory Responsibilities” (issued in June 1999).

This NASD Notice provides a sweeping discussion of what NASD Rule 3010 (governing supervision) requires and discusses at length supervision of firms employing independent contractors in geographically diverse areas. The Notice directs member firms to read the *Royal Alliance* decision, thus confirming that Royal Alliance and its progeny are intended by the regulatory community to set the standard for supervision. As such, Notice 99-45 is a signal of the regulatory community’s continued interest in supervision of independent contractor firms.

Duty to supervise

The duty to supervise is one of the most basic responsibilities of NASD member firms. It arises by rules of the SEC, NASD and the State of Oregon. Broker-dealers, their principals and employees have the obligation to maintain and enforce effective supervision systems. The SEC has said that these rules are a critical component of securities regulation. *John F. Gutfreund,* [1992 Transfer Binder] Fed. Sec. L. Rep. 185,067 at 83,606 (12/3/92). The 1934 Securities Act imposes supervisory duties and severe penalties on all broker-dealers, including license revocation, for failure to comply with these duties. 15 USC § 78o(b)(4)(E). Similar duties and penalties are imposed upon those individuals with supervisory responsibility 15 USC § 78o(b)(6)(A).

Oregon has similar supervisory requirements which are found at OAR 441-205-0210 (Supervision of Associated Persons).

Because the securities industry relies heavily on self-policing, the SEC has said firms and supervisors must use "utmost vigilance" in supervising brokers. *Reynolds* & Co. Fed Sec L Rep. [1957-61 Transfer Binder] 176,702. Supervisors must identify “red flags” in a diligent manner and inquire. *Prudential Bache Securities,* Fed Sec L Rep. [1985-86 Transfer Binder] 183,948. All supervisory responsibilities are heightened when a broker is aware of past improprieties by the employee. *Philadelphia Investors, Ltd.,* SEC Initial Decision No. 123, 1998 WL 122180.

The NASD and New York Stock Exchange (“NYSE”) both have supervision rules. NASD Rule 3010 requires brokerage firms to establish and maintain supervision, have designated offices responsible for supervision, assign each broker to a supervisor, train supervisors, conduct inspections of customer accounts, conduct annual interviews of

brokers to discuss compliance issues, and investigate the character, reputation, qualifications and experience of its registered representatives.

Likewise, NYSE Rule 405(2) requires its members to "supervise diligently all accounts handled by registered representatives of the firm." NYSE Rule 342 requires firms to have designated supervisors for all departments, requires supervisors to supervise and control the activities of employees, and requires the general partners of the firm to provide for appropriate supervisory control. That Rule requires firms to establish a separate system of follow up and review to ensure that delegated authority and responsibility is properly exercised. The Rule also requires a review of transactions and customer accounts.

Safe harbor

There is a "safe harbor" for brokerage firms and supervisors if they have effective, established supervisory procedures in place that would reasonably detect violations. To establish this safe harbor, firms need to prove they actively supervised the account in question. Such proof may include documents establishing a supervisory system, systematic customer accounts reviews, customer inquiries, and the like.

Unfortunately, brokers too often fail to apply such procedures to their satellite offices. Many times, supervision consists of periodic sales meetings and a once-yearly, pre-announce review of select customer files. Too often, the person conducting this yearly review is the contractor's regional manager – the same person conducting marketing meetings and a person who may get a commission override on the contractor's sales.

Independent contractors

There is an obvious tension between the concept of independent contractor, which by legal definition requires lack of control, and a broker's duty to control its registered representatives.

Both the SEC and NASD have made clear that independent contractor status for tax or other purposes has no bearing on a broker's obligation to supervise its registered representatives. The NASD has addressed the supervision of "off-site" personnel and independent contractors as follows:

> Irrespective of an individual's location or compensation arrangements, all associated persons are considered to be employees of the firm with which they are registered for purposes of with NASD rules governing the conduct of registered persons and the supervisory compliance responsibilities of the member. The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements. NASD Notice to Members 86-65, "Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel," 1986 NASD Lexis 386 (Sept. 9, 1986).

In January 1997, the SEC used an proceeding against *Royal Alliance* for its failure to supervise to put the securities industry on notice that independent contractor broker would be held to the same high standards as other broker with respect to supervision. *Royal Alliance* is “part of a pattern of [SEC] public statements and initiatives calling attention to the increased concern over potential supervisory deficiencies in off-site operations.”

Royal Alliance: a warning to industry

The SEC used *Royal Alliance* to send a warning to broker-dealers who supervise sales persons located in' remote locations. Characteristically, these persons are independent contractors. While not forbidding such arrangements (which it could not do without promulgating a rule), the SEC made clear its skepticism that adequate supervision could occur in such firms:

> As discussed above, Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person offices. Here, *Royal Alliance's* failure to scrutinize adequately the securities-related businesses of its registered representatives, which were conducted beyond the direct aegis of the firm, was *a certain recipe for trouble.* Further, Royal Alliance's practice of conducting pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations. Indeed, *we harbor grave doubts* that this practice would necessarily discharge the supervisory obligations of any firm that incorporates a structure in which smaller branch offices are operated by one or two representatives.
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> We do not here suggest that firms which employ offices consisting of one or two registered representatives cannot devise an adequate system of supervision, nor do we discourage such offices. We recognize that many smaller communities are well served by such arrangements and generally cannot support a large office. Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms that are organized in such a fashion, and individual supervisors at those firms, to meet the same high standards of supervision as at more traditionally organized firms. (emphasis added) *Royal Alliance, supra*.

Control person liability under securities laws

Brokers can be liable for the acts of their registered representatives under both the federal and Oregon securities laws.

The provisions of ORS 59.115(3), which make liable persons who directly or indirectly control a seller have been interpreted by the Oregon courts to make liable a broker for the acts of its licensed representative on two grounds: (i) *respondeat superior*; and (ii) a broadened basis of liability based on the *power* to control

The leading case in Oregon so holding is *Badger v. Paulson,* 311 Or 14, 803 P2d 1178 (1990), which incorporates much of the law on control person liability under the federal securities laws as set out in *Hollinger v. Titan Capital Corp*., 914 F2d 1564

(9th Cir 1990).

Subsequently, the Oregon Court of Appeals found that a broker's name on its representative's business card was sufficient for a fact finder to find apparent authority sufficient to hold the broker liable as a control person under ORS 59.115(3). *Ince v. Amev Investors, Inc.*, 122 Or App 66, 69-70, 857 P2d 165 (1992).

In *Castle v. Ritacco,* 142 Or App 89, 95-6, 919 P2d 1196 (1996), the Court of Appeals stated that the language in ORS 59.015(2) makes clear, "[t]he ***power*** to control, whether or not the power is exercised, is the crucial factor" in determining whether a person controls a seller.

Evidence that a seller is a registered representative of an investment company and that the seller is licensed only through that company is sufficient to create a question of fact as to whether the company has the power to control the seller's transactions and is, therefore, liable under ORS 59.115(3) *Id* at 96.

NASD arbitration

If a securities customer has a customer agreement with a securities broker (and most do), then that agreement almost certainly contains a provision requiring all disputes with the broker to be arbitrated. Most such customer agreements provide for arbitration through the NASD or through the NYSE. Such arbitration agreements are enforceable. *Rodriguez de Quijas v. Shearson/American Express, Inc.,* 490 US 477 (1989); *Shearson/American Express, Inc. v. McMahon,* 482 US 220 (1987); *Dean Witter Reynolds, Inc. v. Byrd*, 470 US 213 (1985).

Even if there is no customer agreement, any broker who is a member of the NASD is required to arbitrate claims if a NASD arbitration is initiated by the customer.

Information about the more-commonly used NASD arbitration program can be found at www.nasd.com/ArbitrationMediation/index.htm.

Information about the NYSE arbitration program can be found at online at www.nyse.com/regulation/disputeresolution/1089312755623.html.